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In the

Supreme Court of the United States

October Term, 1977

No. 77-96

BRITISH AMERICAN COMMODITY OPTIONS CORP. AND LLOYD, CARR & CO.,

Petitioners,

—against—

WILLIAM T. BAGLEY, CHAIRMAN OF THE COMMODITY FUTURES TRADING COMMISSION; JOHN V. RAINBOLT III, VICE CHAIRMAN OF THE COMMODITY FUTURES TRADING COMMISSION; READ P. DUNN, GARY SEEVERS, AND ROBERT L. MARTIN, COMMISSIONERS OF THE COMMODITY FUTURES TRADING COMMISSION,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITIONER'S BRIEF IN REPLY TO RESPONDENTS' BRIEF

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REPLY BRIEF OF PETITIONER LLOYD, CARR & CO.

Argument

1. The function of the double segregation rule, as proposed by the Commission in application to commodity option speciality dealers such as Petitioners, is to separate the receipts of sale to a customer of a commodity futures option until such time as that paid for option is exercised. Sale of and payment

for the option creates the binding contract between customers and selling speciality dealer. *Heller* v *Pope,* 250 NY 132, 264 and 881. Exercise of the option at a later date, or abandonment of that non-exercised option on the commodity futures purchased on an earlier date—is a function performed by the selling dealer without the charge of an additional service fee or commission. The Commission's double segregation regulation would force the selling dealer to retain, in a segregated customer account, 90% of the original amount received at the time of the sale of the option, until that option is eventually exercised or expires, and then purchase that same option with the selling dealer's funds and pay expenses incurred in connection therewith, including salespersons' commissions. This is clearly an anti-competitive regulation, having the effect of eliminating speciality dealers such as Petitioner and leaving only the large diversified brokers to sell speciality commodity futures options since only they will be able to generate the cash proceeds sufficient to comply with the double segregation requirement.[1]

Further, while double segregation may protect a customer holding an unexercised or not yet expired option in the event of the dealer's insolvency, it does nothing to protect that customer once the option is exercised or expired. It was never a contemplated benefit of an option contract as sold to protect the

[1] See Petitioner British American Commodity Options Corp. Reply Brief, fn 1, page 2, noting that at least one commodity futures option speciality dealer was not able to borrow operating funds as hypothecated by Respondents.

purchaser against a downturn in price, nor should it be imposed by regulation.[2]

2. Respondent suggests that the significance of the double segregation rule is to protect the customer in the case of the dealer's insolvency. If the dealer were insolvent, then, Respondent argues, the customer would recover his or her purchase price from the segregated funds.

However, the rule does not necessarily achieve even this purpose. Respondents have cited authority which they claim supports the proposition that a bankrupt futures commission merchant will be treated as a trustee of segregated funds. The issue, however, has never been squarely presented to this Court. The District Court in *In the Matter of Weis Securities, Inc.* CCH Comm. Fut. L. Rep., 20,108 decided 10/23/75 (S.D.N.Y.), cited by Respondent in support of its position, observed in dictum that had there been segregation of their purchase money, customers would have had a priority to those funds. The other case relied on by the Commission, *Seligson* v *New York Produce Exchange,* CCH Comm. Fut. L. Rep., 20,029, decided 3/28/75 (S.D.N.Y.), has nothing to do with the segregation rule. Thus, since Respondent cannot clearly assert that customers do have a priority claim to segregated funds in the event of dealer bankruptcy, then there is much uncertainty as to whether the segregation rule would even achieve this purpose.

[2] A commodity futures option obviously will be exercised only if the underlying commodity future is worth more at the time the option is exercised than at the time it was originally purchased and the purchaser will make a profit thereon. However, as can happen in the course of commerce, the underlying commodity future can also suffer a downturn in price such that the option purchaser would not want to exercise that option, for the result would be to purchase a commodity future which is worth less at the time the option is exercised than it was at the time it was originally purchased. Protection against this downturn in price is not a purpose of 17 C.F.R. § 32.6.

3. Respondents claim that Petitioner, Lloyd, Carr & Co. lacks standing to complain about the Commission's registration deadline of January 17, 1977, asserting their application was filed on January 25, 1977. This argument disregards the fact that the January 25, 1977 application was the third such application filed by Petitioner, and that it was filed solely at the request of the Commission. The second application, filed on January 17, 1977, was in every way sufficient. The first application was filed October 1, 1976. As such, each application is similar to a supplemental pleading, none stating a new cause of action, *Jenkins* v *Internation Bank,* 127 US 484, or similar to the substitution of plaintiffs not changing the cause of action, *Missouri K.T.R. Co.* v *Wulf,* 226 US 570, but relating back to the original pleading. In the same manner, each application was a continuation of the original, and in effect, a supplement, and thus date of filing should relate back to the date of the original application. See, *Maty* v *Grasselli Chemical Co.,* 303 US 197; *Louisville & NR Co.* v *Sloss-Sheffield Steel & J Co.,* 269 US 217.

Further, Respondent's observation does not address the thrust of Petitioner's argument, which is grounded in the potential for abuse of discretion by the Commission in its setting a registration, as opposed to a filing, deadline for applications. In fact, the arbitrary and capricious manner in which the Commission did exercise its discretion in the case of Petitioner's application demonstrates that this is not a groundless concern.

4. Respondent claims to have checked 14 of 60 commodity option dealers and claims 12 of the 14 inspected "substantially complied with the regulations". Therefore, Respondent argues, the challenged regulations will not drive commodity options dealers out of business.

The argument is specious, at best. That unnamed brokers are able to "substantially comply" with these regulations does not warrant the inferred conclusion that those regulations are

reasonable. A firm may comply with a regulation for reasons having nothing to do with whether that regulation is constitutionally permissible.

Further, the Commission does not indicate the basis on which the 14 dealers were selected, and on what basis "substantial compliance" was determined. Indeed, the lucky 12 dealers deemed to be complying with double segregation may very will be those large multi-marketing dealers who, Petitioner maintains, are the only brokers capable of complying with the double segregation regulation. On the other hand, they may have been dealers with a commodity futures option sales volume so small, that double segregation involves no burden at all. In any event, the Commission's contention involves facts dehors the record and is not properly before this Court.

What is worthy of the Court's consideration is that the Commission changed its regulations without following statutorily mandated proceedings and now, instead of requiring 90% segregation seeks evidence only of "substantial compliance". Or, perhaps the Commission has recognized the validity of Petitioners contention that the double segregation regulation is incapable of being complied with, and is unreasonable, and that therefore, "substantial compliance" will establish sufficient customer protection. If this be the case, then Petitioners' maintenance of customer segregated accounts should amount to such "substantial compliance" and Respondents should not now be permitted to argue Petitioner is in violation of these regulations.

It is also noteworthy, as stated above, that Respondents do not define "substantial compliance", nor whether they intend to determine this on a case-to-case basis. The potential for abuse of its statutory mandate is manifestly evident. No certainty exists in these vague standards; they constitute no reliable guide by which any specialty dealer can self-regulate its conduct to come within "substantial compliance" and avoid an adverse

determination by Respondents. Respondents thus afford themselves opportunities for arbitrary, capricious and discriminatory enforcement of their own regulations.

Further, Respondents strongly argue that since they are now in the process of changing the double segregation regulation, this Court should not consider the present regulation's validity. Quite apart from ignoring the burden on firms attempting to comply with the regulation during the interim period of its validity—or those firms driven out of business or which never entered into the business because of this regulation—the Commission itself acknowledges the validity of Petitioner's argument by acknowleding the need to substantially change this regulation.

Respondents also stress that Petitioner has made claims of "industry-wide financial collapse" due to the enforcement of the regulations and that since this has not happened, the regulations must indeed be reasonable. This is a melodramatic version of Petitioner's claim that these regulations, if enforced, will seriously and unduly undermine a legitimate industry[3] to the detriment of the general public as well as that of the speciality dealers and their employees. Also, since the regulations have been in effect just more than one year, it is only with extensive uncertainty that Respondents would be able to conclude that these regulations cause no undue burden to the industry. Actually, these regulations have in fact proved to be

[3] Although the Commission, on occasion, has claimed that regulation of the commodity futures options business might best be served by the total prohibition of commodity options trading, ***Business Week***, August 15, 1977 p. 44, the Commission has not recommended prohibition of commodity futures trading. Yet, the potential loss to the customers who purchase a commodity futures option is much less than if that customer had purchased the underlying commodity future, in that if there is a downturn in the price of the commodity futures after the date of the purchase of the option, the purchaser's loss is limited to the purchase price of the option itself instead of losing the total value of the downside price of the commodity futures itself.

so burdensome and unworkable, that they are being changed dramatically by the Commission's own admissions.

5. Respondents strain the language of Section 4C (b) of the Commodity Exchange Act to find a Congressional mandate that, "The Commission could bring all option selling and trading to a halt if it should conclude that such a step is necessary."[4]

Apparently, the Commission, speaking through its Chairman, has already determined that commodity option activities are not in the public interest. See *CCH, Commodity Futures Law Reports, No. 53 July 29, 1977, P. 1.*

The Commission's interpretation is not necessarily a fair implication of the Congressional language, as while the statute provides that commodity options may not be traded contrary to a Commission regulation, it does not expressly or necessarily say that the Commission could prohibit all commodity option transactions. If Section 4C (b) of the Act were to be accorded the construction advanced by the Commission, then the provision itself should be found to lack the guiding standards necessary to redeem it from being an embodiment of an unconstitutional delegation of legislative power and, in this reference, should be determined to be unenforceable. *ALA Schechter Poultry Corp.* v *United States,* 295 US 495 (1935); *Panama Ref. Co.* v *Ryan,* 293 US 388 (1935). Neither the Commission's own regulations nor the Congressional language suggest the situation in which commodity options would be outlawed, nor does the Commission submit a statement of legislative policy which would support its interpretation. *Zuber* v *Allen,* 396 US 168 (1969). Thus, the case at bar is distinguishable from those instances where this Court has upheld such delegations of legislative authority. Even if Congress had intended to permit the Commission to eliminate all options trading, the absence of standards indicates that the Commission's regulations to effectuate such a policy would be

[4] Brief for the Respondents in opposition, p 11.

hardly within the category deemed "subordinate" to specific legislation. *United States* v *Roch Royal Co-operative,* 307 US 533.

6. The Commission raises anew factual issues concerning an alleged absence of value to the existing London segregation of customer funds. Their contentions, although presented on a *different factual basis* below, were considered and rejected by the District Court, and attempts to introduce new facts before this Court should be rejected. Similarly, the Circuit Court's attempt to substitute its factual conclusions for those of the trier of fact should be rejected.

Judge Knapp, after reviewing carefully the full record, determined, using the appropriate standard, that "as a conclusion of fact" Petitioner is threatened by irreparable harm and as a "conclusion of law" for reasons outlined in the Court's opinion, Petitioner has a reasonable likelihood of success on the merits. Further, the Court concluded that the public interest would not be adversely affected by preliminarily enjoining the segreation requirements given the entire regulatory package as adopted by the Commission without double segregation. In arriving at this judgment, the Court specifically cited an absence of any evidence submitted by the Commission on the issue of harm to the public.

Judge Feinberg, speaking for the Second Circuit, slides by the factual finding of the District Court and does not indicate whether there is disagreement on findings of fact or conclusions of law and does not indicate by what standard the decision below is reversed, but simply concludes "the District Judge erred". This is not a sufficient basis for reversal of an order granting preliminary injunction as a matter of law in cases involving a review of rule-making by a District Court, and should be addressed by this Court in this case. Davis, *Administrative Law of the Seventies.* § 6.00 *et seq.*

The new facts presented by the Commission in opposition to this Petition try to suggest that the absence of customer identification by the London options exchange member is a

fatal defect to customer protection. Nothing could be further from the truth, as the Commission must know. The Securities and Exchange Commission, which this Commission has often cited as the model for many of its regulations and with which this Commission works closely, has permitted precisely the same system of customer protection for stock option customers.

This late allegation by the Commission dramatically demonstrates the danger inherent in an appellate court substituting its judgment for the fact-finder's judgment based upon new arguments and restructured facts arising out of rule-making proceedings. Had this argument been presented below, rather than introduced for the first time before this Court, the customer protection practices of domestic options exchanges in securities, which are precisely like those of the London Commodity Option exchanges in this regard, would now be before this Court.

CONCLUSION

For the foregoing reasons, as well as those urged in this Petition, a writ of certiorari should be granted.

Respectfully submitted,

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